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SENSITIVE
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DEPT FOR EAP/MTS AND EB/IFD/OMA
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COMMERCE FOR 4430/KELLY
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR CURRAN
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SUBJECT: BANK INDONESIA RAISES RATES, AS INFLATION
ACCELERATES

REF: A) JAKARTA 1082 B) JAKARTA 1033 C) JAKARTA 1007

11. (SBU) SUMMARY. The Indonesian Central Bank, Bank Indonesia (BI), raised policy interest rates by 25 basis points to 8.75% on July 3, in line with market expectations. Indonesia's headline consumer price inflation rate rose 2.46% in June, driven by continuing rising food prices and higher transport prices due to the May 24 fuel hike. The 11.03% y-o-y inflation figure released in June cannot be properly compared to the 10.4% inflation rate registered in May due to significant methodology changes beginning with the June inflation data, particularly the use of a new base year and changed product weightings. Y-o-y inflation would have registered over 12% without the methodological changes, according to analysts. The Indonesian Statistics Agency did not report a core inflation rate for June. END SUMMARY.

Higher Transport and Food Costs Drive Inflation

12. (U) Transportation, communications and financial services rose 8.72% m-o-m in June, led by a 12.98% hike in transportation costs following the May 24 fuel hikes (Ref B). Gasoline price increases alone contributed more than a third of the 2.46% m-o-m rise in inflation (0.83%). Food prices also continued rising, with unprocessed food prices up 1.28% m-o-m (driven by a 2.11% rise in the prices of rice, grains and tubers) and processed food, drink, cigarettes and tobacco up 1.33%. It is difficult to gauge the impact of higher fuel and food prices on other products because the Statistics Agency did not release a core inflation rate for June. However, prices were up significantly in each of the seven main expenditure categories, while only a few items registered price declines.

Inflation Would Have Been Higher But For

¶3. (U) The June data inflation reflected use of a new base year (2007 vs. 2002), and the use of a new, larger consumer basket of products (774 products, up from 744), based on a 2007 Cost of Living Survey. The new basket, which reflects changes in buying patterns, reduces the weighting of food (unprocessed and processed) to 36.12%, down from 43.38%, and increases the weighting of transportation to 19.1%, up from 14.47%. Another change included a larger survey area covering 66 cities, up from the 45 cities previously covered. The 11.03% y-o-y headline inflation rate reported in June would have been significantly higher (well over 12%, according to analysts) absent these methodology changes.

Accelerating Inflation Prompts BI to Raise Rates

¶4. (U) June's accelerating inflation rate was widely expected and prompted BI to continue its recent monetary tightening. On July 3, BI raised policy interest rates by 25 basis points to 8.75%, its third consecutive rate hike.

¶5. (U) In remarks following the BI Board of Governors' meeting, BI Governor Boediono said the major source of inflationary pressure in 2008 is the impact of the fuel price hike and soaring food prices. He stated BI also saw mounting demand side pressure in line with the rapid

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expansion in credit and the money supply through the second quarter of 2008. Pointing to indications of increasing inflation expectations, Boediono said BI considered it necessary to hike the BI rate to prevent further impact of fuel and food price increases to prices of other goods. He stressed that BI will stay the course with flexible, measured use of existing policy instruments to curb inflation in 2009 within the 6.5% to 7.5% range, and will coordinate actions very closely with the GOI. Boediono also predicted Indonesia's economic growth will remain strong in 2008 and until the end of the 2009 national elections, buoyed by high levels of private consumption and Government expenditure and adequate export performance.

¶6. (U) A BI press release issued after the July 3 meeting noted BI will continue to closely monitor the condition of the economy, which is still marked by various uncertainties. It also noted BI expects 2008 inflation will reach 11.5%-12.5%. The BI expects Indonesia's balance of payments will continue showing good performance and have a positive impact on the stability of the exchange rate, according to the release. It reported international reserves at end-June were \$59.5 billion, equivalent to over five months' of imports and servicing of official foreign debt. The statement said the overall condition of the banking industry reflected strong performance and resilience. The release concluded that the BI rate policy will be supported by optimization of Open Market Operations and policies for bolstering exchange rate stability.

¶7. (SBU) Analysts had expected both the acceleration in inflation in June and the July 3 BI rate hike. Going forward, most analysts expect BI to continue monetary tightening, as it attempts to anchor inflationary expectations and limit second round effects from higher food and fuel prices. Forecasts of end-2008 BI policy rate have been creeping up and now range from 9% to 10%. A number of analysts view BI's recent tightening moves as too little too late to avoid second round effects from emerging.

With the real policy interest rate remaining 225 bps below the headline inflation rate, some of these same analysts predict BI will be forced to continue to tighten in 2009, despite upcoming elections.

Continued Rising Oil Prices Increase Pressure on the Budget

18. (SBU) The continued rise in world oil prices has also limited the budgetary relief realized from the GOI's May 24 reduction in fuel subsidies. In remarks reported in the press July 3, President Yudhoyono said the GOI may have to spend 205 trillion rupiah (USD 22.2 billion) on fuel subsidies and 80 trillion rupiah (USD 8.66 billion) on electricity subsidies in 2008 if oil averages \$145 per barrel IN 2008.

HUME